

Preference Erosion: Cause for Alarm?

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A few vulnerable economies dependent on a handful of products are most at risk from a loss of trade preferences

IN SUMMER 2004, the 147 members of the World Trade Organization (WTO) approved a framework agreement that lent fresh momentum to the multilateral trade talks under the Doha Round—a momentum that had flagged after the collapse of negotiations in Cancún the year before. At the same time, it has provided the latest setting for the debate about the distribution of the gains from trade liberalization and has brought a sense of urgency about the need for adjustment policies to maximize those gains while minimizing the pains.

While most countries recognize the benefits of dismantling the remaining barriers to trade, some—notably the least developed countries (LDCs) and some small island economies in Africa, the Caribbean, and the Pacific (ACP)—are apprehensive. To ensure that their concerns are reflected in the final text of the Doha Round, the LDCs and ACP countries have joined forces to form the Group of Ninety (G-90).

One of the core issues at stake is that most G-90 countries already enjoy duty-free access for their exports in key markets—such as the European Union (EU) and the United States—in the context of preference schemes aimed at encouraging export growth and economic development in poor countries. This means that they would have little to gain from additional market access at the global level. More important, the multilateral removal of trade barriers would erode the price advantage that trade preferences confer and would expose countries whose exports rely on this advantage to fierce competition from more cost-efficient suppliers.

It is not surprising, therefore, that “preference erosion” has become an obstacle to com-

pleting the Doha Round. The G-90 has called for remedies, including compensatory and other mechanisms, such as measures to promote exports; technical and financial assistance for improving infrastructure, productivity, and diversification, and for development of systems to achieve compliance with technical and sanitary standards; and a laxer application of those standards to G-90 exports. It has also called for WTO members not to take measures that would further erode preferences so as to enable preference beneficiaries who trade on a limited number of products to continue to benefit from an “equitable” share of the world market.

Preference erosion can also occur outside the multilateral context—for example, when export partners eliminate preferences, expand the number of preference beneficiaries, or lower most-favored-nation (MFN) tariffs unilaterally without lowering preferential tariffs proportionately. It is in the latter context that ACP countries have opposed recent EU plans to reform its banana and sugar regimes, which are aimed at the gradual dismantling of the high trade barriers for these products.

Just how many countries would be hard hit by preference erosion and how great would be the hit? In a recent study, we undertook to quantify the “value” of preferences and estimate the impact of preference erosion on middle-income countries—that is, countries with a per capita gross national income of \$766 to \$9,385, as defined by the World Bank. Our findings, which are based on a simple, partial-equilibrium analysis, show that the impact is likely to be small overall, with the problem heavily concentrated in a few preference beneficiaries—



magnitude of preferences for which a country is eligible, the export-product concentration, and the utilization of preferences. The robustness of a country's economic environment and the macroeconomic significance of the sectors dependent on the preferences are further important factors.

The vulnerability to preference erosion rises with higher export-dependence on preference-granting countries. About a fifth of middle-income countries direct more than 75 percent of their exports to Canada, the EU, Japan, and the United States, a group known as the Quad. These middle-income countries are, at the same time, eligible for highly preferential market access terms. A further third of the countries send between 50 and 75 percent of their exports to the Quad, although the preferences for some of these countries are not as deep as those of the first group.

The larger the value of preferences, the more the preference beneficiary stands to lose from preference erosion. This value can be quantified by computing a "preference margin"—the percentage by which the trade-weighted average unit price received by a preference recipient for a particular product exceeds that received by an MFN exporter, due to the former's eligibility for a preference scheme. Examples of such schemes include the EU's Cotonou Agreement with ACP countries, the U.S. African Growth and Opportunity Act, Japan's Generalized System of Preferences, and free trade agreements with the Quad, such as the North American Free Trade Agreement or the Euro-Med Association Agreements.

Trade preferences under these schemes may take the form of lower tariffs, larger quotas, or laxer rules of origin, which determine the amount of cheap foreign inputs that can be used in production in order for a product to qualify for preferential trade access. To the extent that preferences are not only in the form of lower tariffs, the preference margin for a given scheme will differ among producers, depending on the market structure and the producers' cost functions—with the more efficient producers having a lower preference margin, as they are able to export higher quantities competitively at the lower MFN price to the world markets.

The concept of "preference margin" provided a clear-cut tool for ranking countries according to their vulnerability to preference erosion. It also allowed, under a set of specific assumptions, simplification of the definition of preference erosion as the decrease in the average unit price of a preference beneficiary in the market of a given partner as a result of MFN-based import liberalization by that partner.

Two of these assumptions were that preferential schemes are fully utilized for all eligible product categories, and that all rents from preferential access accrue to the exporter. Both

primarily small island economies dependent on an even fewer number of products (sugar, bananas, and, to a much lesser extent, textiles). The comparatively smaller significance of textiles reflects the fact that our study abstracted from the impact of the expiration of textile quotas under the Agreement on Textiles and Clothing at the end of 2004, and considered only the rents from lower tariffs to preferential textile exporters.

Similar results were obtained in an earlier paper by Arvind Subramanian that focused on low-income countries—namely, the impact of preference erosion would be significant for only a small number of countries heavily dependent on a narrow set of products (notably tobacco, textiles, fisheries, and cocoa). Any solution, therefore, should be narrowly targeted at the countries and sectors at risk.

Quantifying vulnerability

What makes countries vulnerable to preference erosion? Vulnerability arises from a combination of factors, including the export dependence on preference-granting partners, the

of these are important, as they determine the price that an exporter receives for its product. For example, to the extent that utilization is not total—say, due to lack of awareness of a particular scheme or insufficient administrative capacity to implement strict rules of origin requirements—the average unit price received will be lower than predicted by the full utilization assumption. This would tend to lower a country’s preference margin.

We also assumed that the response of export supply to a change in price is constant. This is a very simplistic version of reality and may lead to an underestimation of the potential costs of preference erosion to a country. The reason is that, given, for example, fixed costs, state subsidies, domestic price rigidities, and land constraints, the response of supply is likely to be highly price-dependent. In certain cases, especially in small markets, a discrete reduction in price due to the erosion of preferences may prompt the closure of key players in the sector, causing a more severe export loss than predicted in our simple cross-country simulation.

Finally, we assumed that a change in the trade policy regime of preference-granting countries would not lead to a change in world prices. Typically, this will not hold, especially if these countries are large. Depending on the countries’ import elasticities for each good, the lower tariffs should raise their demand and thus put upward pressure on world prices. This would tend to counterbalance, to some extent, the decrease in the price received by preference beneficiaries from the reduction in preference margins. At the same time, the extent of the price increase would also depend on the supply elasticities of the more efficient producers and the degree of competition in world markets.

Most vulnerable

Which countries would be the most vulnerable to a loss of preferences? Our results indicate that preferences hold significant importance for a number of countries, notably small island economies (see Chart 1). For six middle-income countries in particular—Mauritius, St. Lucia, Belize, St. Kitts and Nevis, Guyana, and Fiji—preferences add around one-fourth or more to the value of exports. The overwhelming importance of sugar and banana preferences is striking. Together, these two products account for three-fourths of the value of preferences received by the largest beneficiaries. Textiles and clothing score a distant third, while other products contribute only minor shares on average.

Assuming a hypothetical 40 percent reduction in each country’s preference margin as a result of MFN-based liberalization by the Quad, we estimated the impact of preference erosion on export revenues. The results show that several countries could experience significant

declines, even if export supply does not respond much to price changes (see Chart 2). Results would differ to the extent that the actual reduction in each country’s margin is different from the posited 40 percent, following the final outcome of trade negotiations. In any case, any adjustment in MFN tariffs, and therefore the erosion of preferences, is very unlikely to be implemented abruptly. Under realistic scenarios, tariff adjustment will be phased over many years, and the impact on the exports of preference recipients in any given year would be much smaller.

Not surprisingly, given its large preference margin, Mauritius emerges as the country most exposed to preference erosion, primarily because of the highly preferential terms on which it exports sugar to the EU. St. Lucia is another, with the key source of vulnerability being the large contribution of the banana sector to total exports, as well as the depth of the preferences it receives from the EU. In fact, sugar and banana preferences are the source of vulnerability for the 10 most exposed countries, with the exception of the Seychelles, whose vulnerability is associated with preferential access to the EU market for fish-related products.

The degree to which a large shock to merchandise exports will translate into a significant macroeconomic shock will depend on a country’s broader macroeconomic vulnerabilities stemming, for example, from high debt-to-GDP ratios or rigidities such as inflexible labor markets or exchange rate regimes. While, in theory, a government could respond to such shocks by, for example, providing transfers to the economic sectors that have been hurt, in practice, expansionary fiscal policy may not be an option if it leads to an increase of what is already an excessive debt-to-GDP ratio. As a matter of fact, a subset of countries that is most vulnerable to preference erosion includes those that have debt-to-GDP ratios in excess of 100 percent—Dominica, Jamaica, and St. Kitts and Nevis—while for the Seychelles and Guyana the gross debt is almost

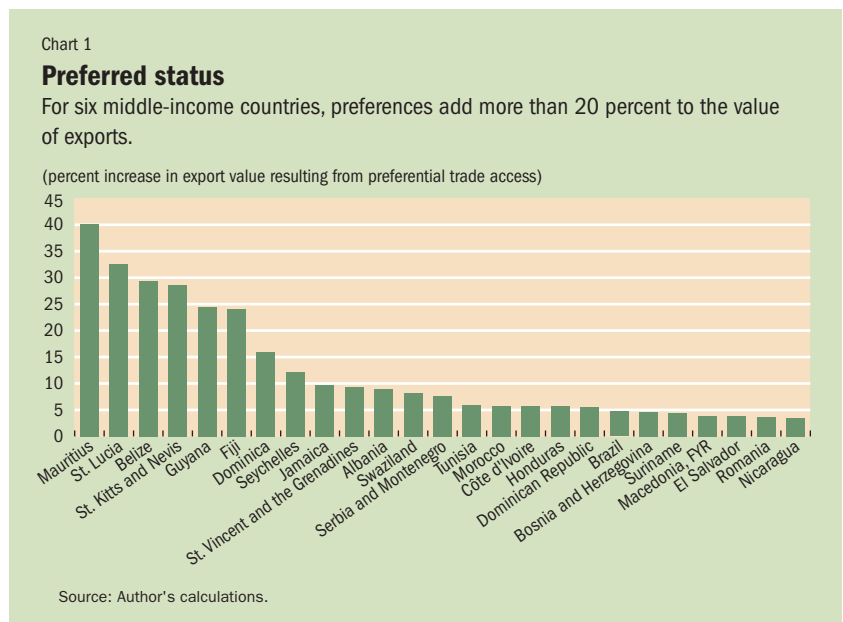
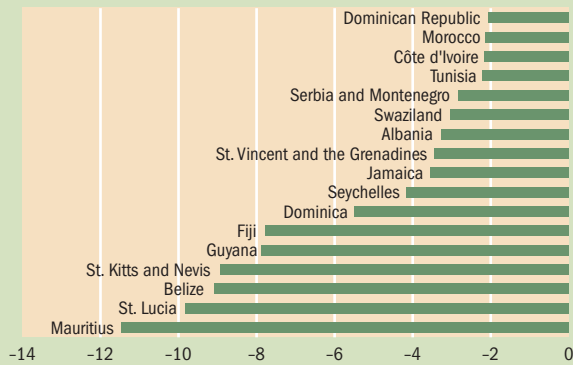


Chart 2

Islands hardest hit

A 40 percent reduction in the preference margin could lead to a major decline in export revenues.

(percent decline in export revenue)



Source: Author's calculations.

twice as large as their GDP. Inflexible exchange rate regimes in some of these countries can introduce further rigidities.

Proposed remedies

Are the alarm bells rung by the G-90 justified? Our study shows that the answer is yes, but with the qualification that the problem is concentrated on a small number of countries dependent on an even smaller number of products. The policy response should thus focus on these countries and sectors—with particular attention paid to developments in the EU and U.S. regimes for specific products, such as sugar, bananas, or fisheries, regardless of whether they occur within the multilateral liberalization process.

Policy-makers must also weigh the pros and cons of different types of support for the most vulnerable. Proposals by various stakeholders have included establishing a fund for affected preference beneficiaries to finance adjustment by the private and public sectors, such as infrastructure and capacity building, the promotion of small- and medium-sized enterprises, and the development of social safety nets. Commonwealth Secretariat studies on small vulnerable economies have called for laxer trade-related standards and more liberal rules of origin for these countries, exemptions from the Doha Round provisions on export subsidies, and financing initiatives to offset export losses from preference erosion.

For its part, the IMF approved a new financing policy in April 2004—the Trade Integration Mechanism, which aims to provide extra assurances to countries experiencing unforeseen balance of payments pressures as a result of MFN liberalization by third countries, with preference erosion being one of the possible sources of such pressures.

The idea of treating especially vulnerable, less developed economies in a manner that is well tailored to their circumstances has gained some currency at the WTO. But attempts to further segment the membership (beyond the “developing country” and “least developed country” designations) have

not been successful so far. Segmentation would be motivated by the fact that many G-90 countries tend to be small island economies fraught by diseconomies of scale in production, limited infrastructure, and a heavy exposure to adverse exogenous shocks, and where candidates for the development of more competitive alternative industries are not obvious.

However, the granting of permanent preferences for these countries, by means of the complete elimination of all trade barriers to their exports, would be controversial for a number of reasons. First, the literature on the economic benefits and costs of preferential schemes for preference recipients themselves remains inconclusive. The stated *raison d'être* of unilateral preferences is the encouragement of export-driven economic development, but there is little empirical evidence that they have been successful. Moreover, there are important costs, including the distortion of incentives in resource allocation, disincentives for trade liberalization, and the administrative burdens of dealing with documentation and rules of origin. In addition, the indefinite extension of preferences would merely postpone the resolution of the problem to a later date and continue to act as a stumbling block to further multilateral liberalization in the future.

Second, the granting of preferences to a particular group of developing countries usually comes at the expense of other developing countries that do not enjoy the same depth of market access. For example, Ecuador and Honduras face far higher trade barriers for their bananas in the EU market than do ACP countries, which enjoy very favorable market access under the Cotonou Agreement. This raises doubts about the rationale for trade preferences, as there is no reason why the promotion of development should discriminate, among the poor, depending on their country of origin.

The way forward will require action by all parties. The text of the WTO's July framework agreement made explicit reference to preference erosion, recognizing it as an issue that ought to be addressed in the Doha Round. But solutions should remain within the boundaries of a rules-based, non-discriminatory system, with the ultimate objective being the integration of all participants into the global economy. A speedier opening of trade by the stronger developing countries would be equally important, as it would open opportunities for South-South trade, the benefits of which remain to a large extent untapped. It would thus help mitigate the negative effects of preference erosion on vulnerable countries by expanding their market opportunities and improving their terms of trade by boosting world demand. ■

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